Financing a Private Sector Recovery

The BVCA's Response to the Green Paper on Business Finance

Summary of Recommendations

The BVCA agrees with the strategic assumptions and ambitions of this green paper, that the key for lasting economic recovery will be private sector growth, principally brought about by increasing access to finance for SMEs. The following are ways the private equity and venture capital industry can assist in that end.

1. We believe that it can be an under-appreciation of, rather than a lack of appetite for, equity finance that is the principal issue and that the Government could help in reducing this "information asymmetry". The BVCA would be delighted to work with HM Treasury and BIS in setting up an "Entrepreneur's Academy", in conjunction with one of the UK's leading business schools, to help instil in entrepreneurs the broad range of skills required for achieving business success, with a particular emphasis on finance. We need to do more to "normalise" equity finance as a viable option for UK SMEs.

2. To help plug the equity gap for growth capital for SMEs, we would recommend a fund-of-fund structure as the most cost and operationally effective method of combining a strong focus on the Government's key aims with access to the broadest investment talent currently available. The GCF should have an "evergreen" structure to ensure that not only are businesses backed over the long term, but also the proceeds of the sale of an investment can be recycled into new investment opportunities.

3. In order to encourage business angels, and to reward them for the considerable risks that they undertake, we recommend a relaxation of Entrepreneurs Relief rules to cover, a) angels and other non-employee private individuals who invest at risk and b) employees who have less than a 5% equity stake. This could be achieved by removing the employment requirement and the 5% minimum holding. We would also support a lifting of the £5 million lifetime gain cap to encourage greater aspiration for growth and also the current £120,000 cap on EMI schemes. EMI schemes should be made available to both non-executive directors and part-time employees.

4. One other potential concern of SMEs in raising private equity and venture capital finance could be the impression that such sources only provide, at best, medium term finance (ie. 3-5 years) to cover a particular phase in a company's development. On that basis, we should look to expand the use of VCTs, one such source of evergreen finance. We would like to see an increase in the employee limits from 50 to 100 or 250, and the annual investment limit to £5 million. This would enable VCTs to invest in any company defined by the European Union as an SME and further enable VCTs to fulfil their core role of helping to close the Equity Gap.

5. We share the Government's view of the ongoing importance of the Enterprise Finance Guarantee Scheme. We were therefore pleased to see it increased by £200m in the Budget. We would like to see it made more attractive - tax incentives could be deployed to increase the attractiveness of EFGS to banks by allowing banks to write off future tax liabilities (spread over, say, the next four years) by the total amount they lend through the EFGS over the next two years. Consideration should also be given to EFGS-backed lending by institutions other than banks; this could apply, for instance, to private equity or venture capital firms that are already familiar with the issues involved in providing finance to SMEs. Venture debt has been a growing source of finance for UK SMEs in recent years[1] – expanding the EFGS to include this would be a useful and very low-cost step.

[1] See 'The rise of Venture Debt in Europe', BVCA research report from May 2010, available upon request.

Financing a Private Sector Recovery

The BVCA's Response to the Green Paper on Business Finance

Introduction

The BVCA is the representative body for private equity and venture capital in the UK. Our 450 members cover the whole investment spectrum, from venture capital firms investing into high growth technology start-ups to the largest global buyout funds turning around and growing mature companies.

The BVCA welcomes the Green Paper on Business Finance prepared by HM Treasury and the Department for Business Innovation and Skills. The BVCA shares the Government's desire to rebalance the economy towards the private sector to help foster sustainable job creation throughout the UK. As an industry with a track record in fostering innovation and private sector growth we stand ready to help the Government fulfil its aims.

Entrepreneurs and SMEs are the job creators in our economy. If we are to create lasting private sector employment, particularly in our neglected regions, we must dramatically improve their access to finance. Bank finance will remain important but the financial crisis has shown us the damage that an excessive reliance on one source can do. This will help smooth out the credit cycle by plumbing diverse sources of finance. As one such alternative, the private equity and venture capital industry is keen to contribute where it can. With the right regime of tax and regulation, and targeted interventions to support venture capital we can return to a path of sustainable and diversified economic growth.

Qs 1./14. ***Background to Crisis***

We agree strongly with the emphasis on the role of the mis-pricing of risk in the creation and exacerbation of the recent financial crisis. In general, it is clear that the provision of the necessary skills, especially in banking and investment, is crucial to the financing of an economic recovery. In the past few years, however, it has often seemed as if these skills were in somewhat short supply, particularly in the banking sector and we would suggest that there is a strong argument for the recalibration of banking skills at all levels. These should include a return to the core competencies of bank lending, namely the provision of trade finance through working capital facilities, and longer term asset finance.

While the Green Paper spends some considerable time reviewing the potential sources and structures of finance, it pays less attention to the provision of the necessary skills to implement those proposals. We would also note the considerable importance of investment skills, particularly in the private equity and venture capital sector, which can be crucial in helping private companies grow and prosper in an uncertain macro-economic environment. These skills cover both the broader business mentoring across all disciplines of an investee company's activities, and also the core financial disciplines which have been seen to be lacking elsewhere in the financial sector.

Q2: Tax and Regulatory Regime

We strongly believe that consistency and reliability in tax and company regulation are essential components to long term economic growth. The PWC Enterprising UK Survey 2009 noted that "Simplifying the tax rules remains the most popular measure Government could take to lighten the burden of compliance, but an increasing proportion of companies are calling for a reduction in uncertainty and the rate of change, up from 8% in 2006 to 17% in 2007, and reaching 25% [in 2009]". PWC goes on to comment that "Leaders of private companies are asking for as much certainty as possible in the tax system. They want to be able to make long term business decisions with confidence that rule are not going to change suddenly." The BVCA fully endorses these views.

Q5. ***Regional finance***

Although the BVCA believes that the Equity Gap applies across the UK, the regions still suffer the handicap of distance from the UK financial centres. The BVCA supports the Government's continuation of a regional investment strategy and we look forward to further details on the nature and role of Local Enterprise Partnerships (LEPs). Given their mixed record, we understand the reason behind the demise of RDAs, although in certain areas they provided invaluable support to venture capital finance. We would therefore encourage LEPs to retain a strong regional structure and provide strategic business leadership in their areas. [2]

We are less enthusiastic about regional stock exchanges, however. While any initiative to broaden the investment base in regional SMEs is welcome, we consider that the vicissitudes of AIM, which despite its undoubted success during "boom" years has suffered significant lack of liquidity (resulting in a halving of its constituents over recent years), will be mirrored, and indeed magnified, in any system of small, regional stock exchanges.

Q6. ***Growth Capital***

We note the Government's thoughts on the Rowlands Review and the Growth Capital Fund ("GCF"). Our own view on the characteristics required by such a fund are as follows:

1. We would recommend a fund-of-fund structure as the most cost and operationally effective method of combining a strong focus on the Government's key aims with the access to the broadest investment talent currently available.

2. The GCF should have an "evergreen" structure to ensure that not only are businesses backed over the long term, but also the proceeds of the sale of an investment can be recycled into new investment opportunities.

3. The GCF should be of a sufficiently large size to make a genuine economic impact. This could be achieved either by encouraging the clearing banks to provide more than the £2-300 million currently mooted, or by encouraging additional sources of equity finance. This second option would have the additional benefit of providing the GCF with the quality hurdle that is entailed by the ability to raise third party funds.

[2] See BVCA response to BIS Select Committee Enquiry on LEPs - http://admin.bvca.co.uk/library/documents/BVCA_evidence_on_LEPs_August_2010.pdf

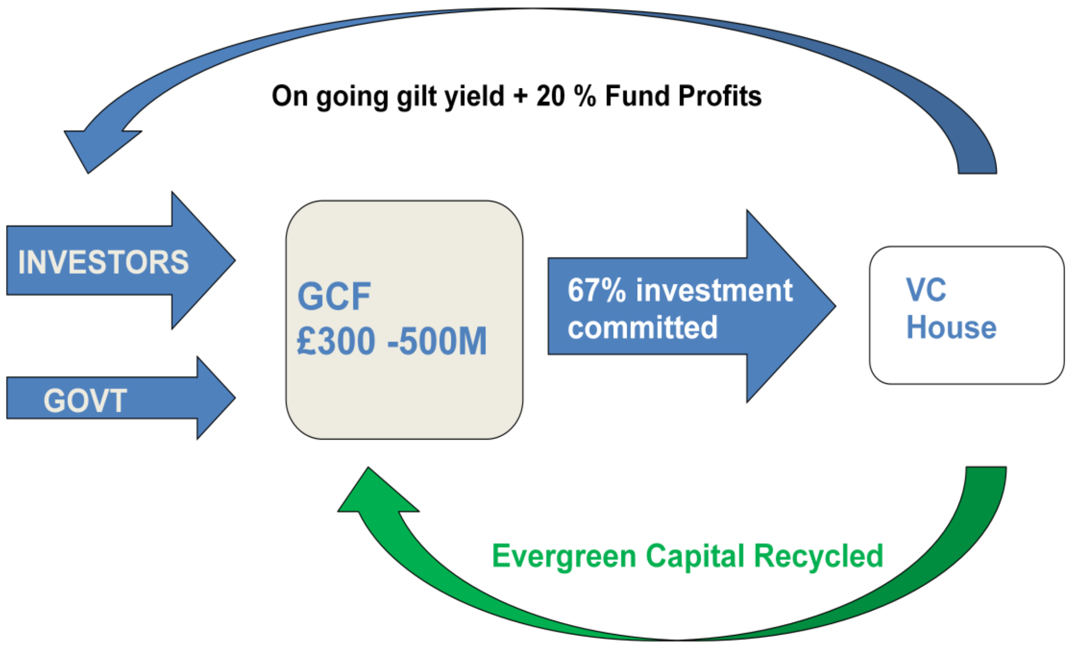
4. The GCF rules should be structured such that it encourages co-investment with other forms of equity, mezzanine and debt finance.

5. The management of the GCF should be such that existing points of delivery are utilised without the creation of new and expensive infrastructures.

6. An investment by the GCF should generate return set by the market rather than more restrictive views as to what level might be acceptable to a mezzanine provider.

7. The definition of "Growth Capital" should be broader than the perhaps slightly narrow focus in the Rowlands Report. We believe that growth capital encompasses SMEs of all stages and sizes, provided that commercial viability has been proved. The GCF should not set any artificial barriers or demarcations regarding the size of an investment or the location of an investee company, but should invest in line with the Government's broader views of the Equity Gap.

With this in mind, in the absence of additional funds from the clearing banks above the levels currently mooted in public, we would recommend a structure based on the current Enterprise Capital Fund. Under this "fund-of-fund" type structure, the GCF would provide 67% of the commitments to third party investment funds with the GCF getting a fixed priority return of capital, with interest based on the yield of 10 year Gilts, and a share of 20% of the third party investment fund profits. Unlike an Enterprise Capital Fund, however, the GCF's principal would be reinvested in new third party funds on the maturity of the previous fund.



<u>Q7.</u> *Angels*

The Green Paper recognises the importance of business angels in the provision of equity finance to SMEs. In order to encourage them further, and to reward them for the considerable risks that they undertake, we recommend a relaxation of Entrepreneurs Relief rules to cover, a) angels and other non-employee private individuals invest at risk and b) employees who have less than a 5% equity stake. This could be achieved by removing the employment requirement and the 5% minimum holding. We would also support a lifting of the £5 million lifetime gain cap, to encourage greater aspiration for growth and also the current £120,000 cap on EMI schemes. Indeed EMI schemes are a particularly valuable tool to reward the stakeholders in a company's success, including those who do not have a full-time role in the company, either because there are too many other calls on their skill base, or because a company's resources are insufficient to take them on full time. We believe therefore that EMI schemes should be made available to both non-executive directors and part-time employees.

We strongly support the view that there should be more syndication across different types of equity investors, from angels through to venture capitalists. We view co-investment and the forming relationships between different types of investor as healthy and constructive. We consider that the old concept of an investment "ladder" whereby different categories of investor will fund different stages of an SME's life, are generally misplaced.

<u>Q8.</u> *Financing Options for SMEs*

We agree with the analysis that the equity gap ranges from £250,000 to as high as £15 million and we consider this to be a pan-UK issue rather than subject to significant regional variations. The Green Paper goes on to comment, however, that the relative lack of use of external equity as a source of finance by SMEs is in large part due to concerns over the ceding of ownership. We would argue that these concerns are less important than HM Treasury and BIS might imagine, and that furthermore the ceding of control is not always the natural consequence of external investment; indeed many VC houses in particular only take minority stakes in businesses.

We believe that it can be an under-appreciation, of, rather than a lack of appetite for, equity finance and that the Government could help in reducing this "information asymmetry". The BVCA would be delighted to work with HM Treasury and BIS with a view to increasing the level of education to SMEs, for instance through jointly sponsored regional seminars on the raising and utilisation of private equity and venture finance. This would in turn help eligible businesses to become more "investment ready". Indeed, the BVCA would be interested in the possibility of setting up an "Entrepreneur's Academy" in conjunction with one of the UK's leading business schools, to help instil in entrepreneurs the broad range of skills required for achieving business success, with a particular emphasis on finance. We need to do more to "normalise" equity finance as a viable option for UK SMEs. We have also begun work on options for information and content sharing with Business Link, to publicise better and help educate SMEs on the merits of equity finance.

One other potential concern of SMEs in raising private equity and venture capital finance could be the impression that such sources only provide, at best, medium term finance (ie. 3-5 years) to cover a particular phase in a company's development. This is in turn driven by the requirements of investors in limited partnership funds, and can at times ill-suit the needs of a business which can extend over many years, and even decades. To help overcome this, it would make sense to encourage longer term sources of equity finance which can support companies over the medium to longer term. 3i, at its inception, and for many years thereafter, was an example of this. Its role in SME finance has now largely been taken over by venture capital trusts who similarly, as evergreen funds, are able to provide finance for up to a decade or more. In addition, like 3i, VCTs capital circulates within the fund rather than being returned to shareholders, leaving the same capital to be used over time to support a number of different companies. We would encourage the Government to reflect on how private equity and venture capital funds with long term characteristics could be extended to provide a broader role in SME finance. venture capital trusts are one example of these, and we suggest below how the proposed Growth Capital Fund could be another.

The BVCA notes the valuable role played by Enterprise Capital Funds (ECFs) in addressing the lower end of the Equity Gap. We believe that the fact that Government money is provided with a prior but limited return, with the main risk and rewards accruing to private investors, achieves a good balance between Government support and the need to build a genuine commercial business case for an individual fund. We would encourage the Government to continue to support the ECF programme and to consider further that potential for using the scheme to attract finance commercialization of university intellectual property.

Q9. *VCT/EIS*

We are encouraged by the continuing support for Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS). We have strong evidence to show their effectiveness in providing finance for SMEs. The valuable role of VCTs and EIS in creating employment and in providing a strong return on the Treasury's investment has been detailed in the March 2010 report prepared by the Association of Investment Companies, "Supporting Enterprise and Growth: the Role of Venture Capital Trusts". The report shows an increase in the workforce amongst 303 investee companies of 47%, while the total annual tax returned by the sample of investee companies amounted to some 67% of the tax cost.

The current EU imposed rules whereby new funds raised by VCTs and EIS could only be invested in companies with less than 50 full time employees, and whereby companies cannot raise more than £2 million, are not helpful in helping companies access the VCT and EIS funds that are currently available. It is interesting to note that in France, where the equivalent of VCTs has been highly successful in raising finance, these tight employment rules do not apply. With this in mind, in the Budget of 24 March 2010, the then Chancellor stated that HMRC and Treasury would work towards trying to increase the employee limits to 100 or 250, and the annual investment limit to £5 million. We strongly urge the present Government therefore, to continue with this process and to extend the annual investment limit in line with its views of the Equity Gap. This would enable VCTs to invest in any company defined by the European Union as an SME, and further enable VCTs to fulfil their core role of helping to close the Equity Gap.

We are also in favour of broadening the range of all securities in which the EIS can invest. Examples of securities currently not permitted include loan stocks and preference shares. A broadening of the range would ensure that there is no conflict with instruments provided by other forms of VC finance and would match the Government's broad aim of encouraging more syndication to enable larger deal sizes.

Q 15. ***Enterprise Finance Guarantee Scheme (EFGS)***

This is a very important scheme and we were pleased to see it increased by £200m in the Budget. It is clearly imperfect – despite the headline 75% guarantee, the real guarantee is very much lower – only around 13% of any banks aggregate exposure under the scheme is actually guaranteed. The simple solution would be to make the scheme easier to operate, and to lift the guarantee level.

Tax incentives could also be deployed to increase the attractiveness of EFGS to banks. Very simply, government could allow banks to write off future tax liabilities (spread over, say, the next four years) by the total amount they lend through the EFGS over the next two years. This should stimulate lending at the same time as helping banks rebuild capital buffers more swiftly via retained earnings. It is also worth considering that non-bank finance lending should also benefit from the EFGS, and consideration could be given to EFGS-backed lending by institutions other than banks; this could apply, for instance, to private equity or venture capital firms that are already familiar with the issues involved in providing finance to SMEs.

Venture debt has been a growing source of finance for UK SMEs in recent years[3] – expanding the EFGS to include this would be a useful and very low-cost step.

Qs 10./16. ***Other measures to encourage bank lending***

We welcome the Green Paper's encouragement of the securitisation of bank loans to mid-sized firms. However, in order for such securitisation to become more prevalent, a cost effective method would need to be established for independent professional corporate trustees to safeguard the rights to investors. In addition, in order for there to be a decent equity market for the securities, pension fund allocation rules would need to be reviewed to allow for a higher proportion of investment in UK corporate bonds. The existing ISA rules could also be amended to make investment easier by the general public. Thirdly, securitised loan packages could include a fixed proportion of loans guaranteed under the EFGS, in order to reduce risk. Finally, the Government could work with the Bank of England by offering to purchase directly the new securitised SME loans on primary markets. With the terms of the Asset Purchase Facility, the Government has provided the Bank of England with up to £50 billion, to invest in private securities. Thus far little of this money has been spent; the Treasury could instruct the Bank of England, on its behalf, to spend some or all of these funds on securitised SME loans.

Conclusion

In conclusion, we would reiterate our view that the affects of the financial crisis are being felt not only in the lack of business finance, but also in the lack of skills required to deliver that business finance. The private equity and venture capital industry, with its longer term, risk taking, financing profile, is well placed to aid the return of finance in small and mid-sized businesses. Set out above is our commentary on how these may be achieved.

[3] See 'The rise of Venture Debt in Europe', BVCA research report from May 2010, available upon request.